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A new justification for full reserve banking?

Ralph S. Musgrave.

Abstract.

Most of the money in circulation is created by commercial banks, and it is precisely that form of money creation that explains most bank failures. In contrast, full reserve banking is a system under which that form of money is banned: all money is created by the **central** bank. There is a very simple reason for such a ban which most if not all advocates of full reserve seem to have missed, which is as follows.

Under the existing bank system, those who deposit money at banks with a view to their bank lending on their money so as to earn interest are into **commerce**, in just the same way as where they deposit money with a stock-broker, mutual fund, private pension scheme or similar with a view to their money being loaned on or invested. And it is a widely accepted principle that taxpayers should not rescue commercial ventures which fail. Yet taxpayer backed deposit insurance is provided for those bank depositors. Thus if the latter principle were adhered to consistently, then there would be no deposit insurance for “interest earning” deposits, while of course totally safe non-interest earning deposits would be available for those who want them. And that “two types of deposit” system is what full reserve has always consisted of.

The above point about commercial and non-commercial depositors is similar to, but not quite the same as the more conventional argument for full reserve, which is along the lines that governments cannot allow a series of major bank failures,

which inevitably means banks are featherbedded or subsidised (a non-commercial activity) thus some way must be found of removing that subsidy, and one way is full reserve.

The first 1,300 or so words below briefly introduce full reserve. The basic argument put in this paper then starts under the heading “Taxpayers should not back commerce.”

Introduction.

Full reserve banking is name for a bank system under which, to over-simplify, private/commercial banks cannot issue money: that is, all money is issued by **central** banks. Other phrases used to describe that system include “100% reserves”, “Sovereign Money” and “narrow banking”.

The latter description of full reserve banking is “over-simple” in that there is no sharp dividing line between money and non-money: almost anything can be used as money. To stretch the point, anyone can try using bottles of whiskey as money. Quite possibly using bottles of whiskey to pay for other goods should be classified as barter, but let’s overlook that technicality: the important point is that even where privately issued money is banned under full reserve, there will still be a number of assets which arguably count as money.

However, there is an important distinction between those “other assets” on the one hand, and what counts as money when it comes to the monetary aggregates which most countries periodically publish, which in turn is the same as what is counted as money in this paper. That is, in this paper, only assets which are government or taxpayer backed are counted

as money. To illustrate, \$100 bills are guaranteed by the US government not to lose value (inflation apart). The same cannot be said of other strange bits of paper circulating on Wall Street which may serve the purpose of money.

As to money issued by commercial banks under the existing bank system, that is also guaranteed by governments via deposit insurance.

One justification for banning commercial bank issued money is that it is precisely the fact of issuing that money that makes those banks fragile, as suggested by Diamond (1999) in his abstract. To put that more bluntly, it is precisely the fact of letting private banks issue money that explains the 2007/8 bank crises and most other bank failures throughout history. It is true that other factors like house price bubbles, liar loans and excessive private debt are often cited as being the cause or contributory cause of bank failures. But as Kotlikoff (2018) rightly argues, those other factors are only **contributory** factors: they are not the root cause of the problem.

The reason why letting private banks issue money makes them vulnerable is that money by its very nature is a **short term** liability of a bank: that is, where someone has money deposited in a bank, (i.e. they have opened a normal instant access / checking / current account) the bank is obliged to pay that money or some of it back to the depositor instantaneously if the depositor so wishes. Alternatively there are deposit / term accounts available at most banks, but much the same applies: the bank is obliged to repay relevant monies within a month or two where the money is in a one or two month term account. In contrast, banks make relatively **long term** loans. That is, banks engage in “borrow short and lend long” or “maturity transformation” to use the jargon.

But that activity is clearly risky: if too many of those a bank has borrowed from (i.e. depositors) withdraw their deposits, the bank may be in trouble, since it cannot demand money back from those it has granted long term loans to (e.g. mortgagors).

Full reserve solves that problem by insisting that bank loans are funded only by **shares** in the bank, or by something that amounts to shares, e.g. stakes in a mutual fund / unit trust which specialises in granting mortgages. Under that sort of regime, if a bank or mutual fund makes silly loans and the value of its stock of loans drops to say 80% of book value, all that happens is that the shares or mutual fund stakes falls to about 80% of book value. That is, the bank or mutual fund does not go bust: its liabilities do not exceed the value of its assets.

As Selgin (1988) put it, “For a balance sheet without debt liabilities, insolvency is ruled out...”. (Incidentally, that was an aside made by Selgin: his book did not actually advocate full reserve).

Full reserve is advocated for example by Cochrane (2013), Dyson (2012), Dyson (2016), Fisher (1936), Friedman (1960), Klein (2013), Kotlikoff (2012), Mellor (2016) and Werner (2011).

Re the central claim of this paper, namely that advocates of full reserve do not seem to have grasped the importance of the distinction between bank customers who are into commerce and those who are not, I have actually searched for the words “commerce” and “commercial” in the latter eight works. While those words obviously appear quite frequently, there is no reference to the distinction between “commercial bank customers” and non-commercial ones, with one exception. That is Dyson (2016). Dyson does briefly allude to the fact that ordinary bank depositors are protected by taxpayer backed

deposit insurance, but that's all. That is in his paragraph starting "The deposits created by banks...".

But Dyson does not actually say that it is not the job of taxpayers to stand behind what is clearly a form of commerce, namely depositors seeking to have their bank lend on their money for them.

As for other words that might be used in place of "commercial" or derivatives of that word, it is not clear what those might be. Thus it very much looks like those who have advocated full reserve to date do not realize how crucial the distinction between commercial and non-commercial depositors is to the debate over full reserve. At the very least, that distinction seems to be under-appreciated in the literature.

Would a partial ban on private money do?

Having suggested above that having bank loans funded via equity rather than deposits stops banks going bust, there is a weakness in that idea, namely that as argued by Wolf (2017) and Admati (2013) it is not actually necessary to totally ban the issue of private money in order to make banks safe. That is, as they argue, it is probably not necessary to raise the capital ratio of banks (or rather banks' "lending departments") to the 100% level: around 20% would probably do.

Given that Cochrane tends to stress the idea that avoiding bank failures is the main justification for full reserve, that is clearly a weakness in the Cochrane style "avoiding bank failures justifies full reserve" argument.

Private money creation equals a subsidy of private banks.

There is however another reason for a total ban on commercial bank issued money, which is that money creation by those banks amounts to, or inevitably results in a subsidy of those banks. One of those subsidies is the well-known “too big to fail” subsidy. That is, banks for reasons given above are prone to failure, but a series of large bank failures cannot possibly be allowed, thus those banks are effectively backed by the state, which amounts to a subsidy. Therefore some sort system where no subsidy is involved must be found, and full reserve meets that need.

Another form of subsidy was explained by Huber (2000, p.31), and that is that letting private banks create or “print” money amounts to a subsidy of those banks.

As Huber puts it, *“Allowing banks to create new money out of nothing enables them to cream off a special profit. They lend the money to their customers at the full rate of interest, without having to pay any interest on it themselves. So their profit on this part of their business is not, say, 9% credit-interest less 4% debit-interest = 5% normal profit; it is 9% credit-interest less 0% debit-interest = 9% profit = 5% normal profit plus 4% additional special profit. This additional special profit is hidden from bank customers and the public, partly because most people do not know how the system works, and partly because bank balance sheets do not show that some of their loan funding comes from money the banks have created for the purpose and some from already existing money which they have had to borrow at interest.”*

Put another way, private banks manage to get the profits from seigniorage to subsidise their money lending business.

Obviously commercial banks do not make a 9% profit (using Huber's figures) on loans funded by freshly created money and a 5% profit on loans funded by deposits, bonds and so on. That is, banks no doubt use their freedom to create a certain amount of new money every year to increase their profits on **all their** loans (and/or cut the rate of interest charged on those loans).

Huber's point certainly ties up with the point made by Selgin (2012) in his opening paragraphs, namely that if commercial banks are allowed to create money in an economy which had previously just used base money (i.e. central bank created money), commercial banks manage to rob those holding base money (not that Selgin actually advocates full reserve in that work of his).

Taxpayers should not back commerce.

There is a widely accepted principle that it is not the job of taxpayers to bail out commercial ventures which fail. But in the case of banks, it is clear that people who deposit money at banks with the intention of those banks lend on that money so as to earn interest are into commerce. They are into commerce in exactly the same way as where they deposit money with a stock-broker, mutual fund or private pension scheme with the same end in view: that is, that the money is loaned on or invested so as to earn interest or dividends. Another example of money lending which comes to the same thing as depositing money at a bank is buying bonds in a non-bank corporation. Indeed, putting money into a two month term account at a bank comes to exactly the same thing as buying bonds which have two months till maturity in a non-bank corporation.

Depositors' intention that banks lend on their money is indisputable in the case of term accounts, but even in the case of instant access accounts, depositors (quite understandably) place their money whenever possible, with banks that pay interest on instant access accounts as well, or at least use interest to defray the costs of administering those accounts.

But for some strange reason, governments offer taxpayer backed deposit insurance for those "commercial" bank depositors, but not for those who place money with mutual funds, stock-brokers and so on. That is a blatant inconsistency.

To illustrate the inconsistency in the starkest possible way, if you lend to a non-bank corporation by buying its bonds, there is no taxpayer backed insurance for you, but if you deposit money at a bank (i.e. lend to a bank) and the bank lends to non-bank corporations (which most banks do) then you're protected by taxpayer backed insurance!

Moreover, in going for the former option, i.e. buying a non-bank corporation's bonds you are cutting out middlemen, i.e. banks. Or should I say, you are cutting out a bunch of recession causing middlemen who have repeatedly been found breaking the law. You'd think that if government is going to interfere in any way here, it would actually **reward** those who cut out the middleman, rather than assist those middlemen, which is what governments do at the moment.

There is however a simple solution to that inconsistency, which is to draw a sharp distinction between depositors who wish in effect to be money lenders and those who do not. That is, it would be perfectly feasible to have two categories of bank account. First there could be accounts for "commercial depositors" where there is no deposit insurance, and second there could be totally safe accounts for those who want safe

accounts, where money is not loaned on and where money is totally safe. Note that under that system, “commercial depositors” in effect become shareholders in the bank in that if the loans made by the bank turn out to be incompetent, then the commercial depositors bear the cost.

But the latter “two types of account” system is exactly what full reserve has always consisted of! For example, as Fisher (1936) put it, “This means that in practice each commercial bank would be split into two departments, one a warehouse for money, the checking department, and the other the money lending department....”

Incidentally, it might possibly be argued that if “commercialness” is the guiding principle here, employers should not have a right to safe accounts since they are by definition into commerce, while individual people **should have** that right and on the grounds that having a totally safe way of storing and transferring money is a basic human right. On the other hand most advocates of full reserve seem to assume that employers should be able to make use of safe accounts.

There is certainly a debate to be had on that point. However that is a relatively minor point which will not be considered any further here.

Another incidental point is that clearly there are a plenty of objections that have been raised to full reserve, but I will not deal with any of them here because I dealt with lots of them in section 2 of Musgrave (2014).

Note that there is actually a more recent edition of Musgrave (2014) about to be published by “KSP Books” at the time of writing, and the layout and presentation will probably be a bit better than what you will find at the relevant link given in the

references section below. However, the latter section 2 in the 2018 version of the book is actually the same as the version in the earlier edition, so you won't miss much by looking at the earlier version.

What's wrong with deposit insurance if it pays for itself?

In the US, the deposit insurance system, the Federal Deposit Insurance Corporation (FDIC) is self-funding. That is, it charges banks an insurance premium which varies with the perceived riskiness of those banks. And that raises an obvious possible objection to abolishing deposit insurance, namely that if something is commercially viable, it is arguably not obvious what is wrong with it.

The answer to that is that the FDIC is what might be called a "Rolls Royce" insurer in that it is backed by the US taxpayer. That is, everyone knows that if the FDIC fails, the US taxpayer will be forced to bail it out. In other words the FDIC is not a normal commercial insurer.

Second, the FDIC only caters for small and medium size banks. In other words when **large** banks fail or seem to be in trouble, it is the Fed which comes to the rescue, and the trillion or so dollars worth of loans granted by the Fed in the recent crises were most certainly not at the "penalty rates" advocated by Walter Bagehot. They were not even at anything which might be remotely called a "commercially viable" rate. They were at a near zero rate!

In short, the US deposit insurance system **as a whole** is not commercially viable.

Another problem with the “commercially viable” excuse for deposit insurance, is that if that excuse is accepted, then the same argument can be applied to having taxpayer backed insurance for those put money in to mutual funds, private pension funds and the other modes of saving mentioned above.

Moreover, the excuse often given for deposit insurance, namely that it encourages lending and thus increases investment can perfectly well be applied to the latter mutual funds etc and can even be extended to stock exchange quoted shares.

So there is clearly a problem in knowing where to draw the line here. The basic argument of this paper is that there is a very clear natural dividing line between commercial and non-commercial activities, and that is where the line should be drawn.

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